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ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF
BELLA VISTA WATER CO., INC., AN
ARIZONA CORPORATION, TO DETERMINE
THE FAIR VALUE OF ITS PROPERTIES
FOR RATEMAKING PURPOSES, TO FIX A
JUST AND REASONABLE RATE OF
RETURN THEREON, AND TO APPROVE
RATE SCHEDULES DESIGNED TO
DEVELOP SUCH RETURN.

Docket No. W-02465A-01-0776

Arizona Corporation Commission

DOCKETED

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RUCO'S CLOSING BRIEF

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits the following points in support of its position that the Arizona Corporation Commission ("Commission") should not authorize a rate increase of more than \$19,333 for the Bella Vista Water Company ("Bella Vista" or "Company"). RUCO takes issue with the Company's inclusion of post-test year plant additions in its rate base determination, and the manner in which the Company determined its cost of equity. RUCO contends, and the evidence supports, that the Company is recklessly disregarding certain time-tested and generally accepted regulatory principles adopted by the Commission regarding the above issues in order to maximize its revenue requirements.

1 THE REVENUE REQUIREMENT

2 The Company proposes a total rate increase of \$388,764. A-5, Schedule A-1. The
3 Company originally requested a rate increase of \$594,886. A-1, Schedule A-1. In support
4 of its proposal, the Company proposes a rate base that includes \$1,797,279 in post-test
5 year plant additions. In arriving at its proposed rate base, the Company disregarded the
6 requirement of A.A.C. R14-2-103 (B) which requires rate applications be based on a
7 historical test year. Rather, the Company has calculated its revenue requirement by
8 restating its 2000 plant balances to reflect plant additions through 2001 and into 2002,
9 while utilizing expenses for the year 2000. The Company's objective, of course, is to
10 maximize its revenue requirement by submitting a proposal based on the highest
11 balances. Not only does this violate the matching principle, the used and useful principle,
12 and the use of the historic test year requirement, it is inconsistent with prior Commission
13 Decisions.

14 Normally, the Commission relies on the historical test year to determine fair and
15 reasonable rates. RUCO-4 at pg. 8. Fair and reasonable rates can only be determined if
16 there is a matching of all ratemaking elements. The use of a historical test year
17 automatically guarantees a matching of all rate base and operating revenues. Likewise,
18 the use of a fully projected test year could also accomplish matching of all ratemaking
19 elements¹.

20 Outside of special or unique circumstances, the Commission has generally required
21 the following criteria be met for minor or isolated post test-year plant to warrant inclusion in
22 rate base:

24 ¹ RUCO is not recommending that the Commission adopt the use of a projected test year in this case.

- 1) That the cost be known and measurable;
- 2) That the test year revenues match the post-test year investment;
- 3) That the test year expenses match the post-test year investment;
- and
- 4) That the plant be used and useful.

RUCO-4 at pg. 11.

The majority of Bella Vista's post-test year plant additions failed the rate base inclusion test because of the effect the additions have on operating expense levels and the mismatches between test year expenses and post-test years level of investment. RUCO-4 at pg. 12. In other words, the additional plant fails requirements number two and three of the test, as a result rate base inclusion should be denied.

The Commission has allowed post-test year plant additions beyond one year in rare instances. Typically, those cases involve unique and/or special circumstances. In the instant case, the circumstances are not unique or special and do not justify the inclusion of post-test year plant additions in rate base. RUCO-4 at pg. 10. In Far West Water Company (Decision No. 62649), the Commission had ordered in a previous rate case that the company perform a study of its water quality problems. Shortly after the test year ended, Far West filed a financing application and requested authority to incur long-term debt to finance the construction of a treatment plant to resolve its water quality problems. The Commission authorized interim rates on an emergency basis to permit the company to qualify for the financing. In the rate case, Far West requested inclusion of treatment plant additions completed one year and two months beyond the historical test year. In allowing the post-test year plant additions, the Commission noted:

1 "It is unreasonable for the Commission to order the Company to
2 make such an investment that triples its rate base and approve
3 financing, but reject the request for rates that would support the
4 investment and provide a fair and reasonable return. By
5 establishing permanent rates based on this application, we do
6 not intend to create a precedent permitting companies to
7 disregard the requirement of A.A.C. R14-2-103 (B) to file
8 applications based on a historical test year, or indicating that
9 we will approve post-test year adjustments in any other
10 context." Decision No. 62649 at p. 5.

11 In Paradise Valley Water Company (Decision No. 60220) the Commission included
12 plant additions one year and one month beyond the historical test year. During the test
13 year, the company's customers experienced low water pressure and some customers
14 experienced water outages. In order to cure the system-wide deficiencies, Paradise Valley
15 made large post-test year investments in plant. The Commission shared RUCO and
16 Staff's concerns regarding matching rate elements but noted that there were three unique
17 circumstances that prevented its normal use of a "TY cut-off date for including plant in rate
18 base: 1) the Company's CC&N area is almost completely developed with little room for
19 growth; 2) the plant added since the end of the TY is generally to correct system
20 inadequacies that resulted in water outages in 1995; 3) and the magnitude of overall
21 construction is relatively large."

22 The Far West and Paradise Valley cases are easily distinguished from the present
23 case. The Company's post test-year plant additions are not the result of a Commission
24 order, or water quality. Nor were they made as a result of an extraordinary event.
Accordingly, there is no reason to depart from sound ratemaking principles and the
Commission should follow its normal practice of utilizing a historical test year cut off date
for including plant in rate base.

COST OF CAPITAL

RUCO recommends that the Commission adopt rates for Bella Vista that will allow the Company to earn a 9.66% percent return on the Company's invested capital. RUCO-1 pg. 6. RUCO's recommended weighted cost of capital is comprised of a 9.63% cost of long-term debt and a 9.66% cost of common equity. RUCO's recommended cost of equity capital was derived from the discounted cash flow (DCF) model and the capital asset pricing model (CAPM). The DCF model is regarded in the industry as conceptually sound. The CAPM method is the best and most consistent of three methods studied² for determining a company's cost of common equity. RUCO-3 at p. 25. RUCO's cost of capital witness, Mr. William Rigsby, weighed the results of both the DCF and the (CAPM), the two most accepted and accurate methods for determining the cost of equity capital, in order to arrive at his 9.66% recommended cost of common equity for Bella Vista. RUCO-1 at pg. 6. In addition, RUCO's recommended 9.66% cost of equity was derived by using a proxy of sample companies that face the same types of risks as Bella Vista. Id. at pgs. 15-17.

The Company's cost of capital consultant, Mr. Ronald Kozoman, originally based his recommended cost of capital on the upwardly adjusted results of a DCF and CAPM analysis. A-1, Direct Testimony of Ronald Kozoman at pgs. 21-22. However, during the rebuttal stage of the proceeding, Mr. Kozoman abandoned his original methodology in favor of what can best be described as a comparable earnings analysis, which produced a cost of common equity of 10.50%. A-6 at pgs. 21-22. Surprisingly, Mr. Kozoman subsequently became critical of his original recommendation noting that RUCO's use of

² The three methods studied by Kolbe et al. were the DCF, CAPM and comparable earnings. RUCO-3 at p. 25


1 the DCF and CAPM models to calculate the return on equity was a "violation of case law".
2 A-6 at pg. 21. Further, Mr. Kozoman's comparable earnings recommendation is puzzling
3 considering that Mr. Kozoman had previously testified in a recent water company rate case
4 that the comparable earnings analysis was "...so simplistic as to be useless". RUCO-7,
5 Transcript, Vol. II, at pp. 323-324. In the earlier proceeding, Mr. Kozoman testified that
6 the comparable earnings analysis is based on circular logic (i.e. the results are based on
7 returns of utilities that were set by regulators as opposed to relying on forward looking
8 information and taking analysts' projections into consideration). Id. at 323.

9 At hearing, Mr. Kozoman further attempted to confuse and distort the cost of capital
10 issue by restating the results of Mr. Rigsby's DCF analysis. Transcript, Vol. II, at pp. 315.
11 Mr. Kozoman's restatement of Mr. Rigsby's DCF model fails to recognize the dynamics of
12 the model. Mr. Rigsby had used the average of closing prices of the proxy companies
13 over a specified period. RUCO-3 at pgs. 2-3. Mr. Kozoman substitutes a less reliable
14 method using the one-day stock price of the proxy companies. To further augment the
15 unreliability of the model, Mr. Kozoman selects stock prices which were recorded on one of
16 the most volatile days in recent market history and during a period in which investor
17 confidence had been badly damaged by recent accounting scandals involving both Enron
18 and WorldCom. The market was an anomaly on the day Mr. Kozoman chose as the
19 recent panic selling of many traded equities was occurring for "no sound reason."
20 Transcript, Vol. 1, at pp. 180, RUCO-8 at pg. 5. In effect, Bella Vista is asking the
21 Commission to ignore the results of reliable methodologies (i.e. DCF and CAPM) in favor
22 of a method its' expert previously dismissed but is now recommending because of the
23 favorable result for the Company.

1 **CONCLUSION**

2 RUCO recommends that the Commission authorize Bella Vista a rate increase of no
3 more than \$19,133. RUCO further recommends that the Commission deny the Company's
4 request to approve post-test year additions. Finally, RUCO recommends that the
5 Commission approve a 9.66% weighted cost of capital.

6 RESPECTFULLY SUBMITTED this 12th day of September, 2002

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8 
9 Daniel W. Pozefsky
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13 of the foregoing filed this 12th day
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